

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion in conjunction with our combined financial statements and the accompanying notes and other financial information appearing elsewhere in this prospectus.

Components of Revenues

We derive our revenues from three operating segments: access, hosting and transport. Our other revenues include international and value-added e-business services.

Access. Our Internet access services include dial-up, dedicated and digital subscriber lines. Our access revenues, which are derived from service providers and enterprise customers, are the largest component of our total revenues. Internet access customers typically sign one or two-year contracts providing for monthly-recurring service fees that are either fixed or based on capacity utilization. We also include in our access segment those revenues relating to the development, operation and maintenance of a nationwide dial-up network for America Online. We derived approximately 42% of our total revenues from America Online in 1997, approximately 53% in 1998, 52% in 1999 and 46% in the first quarter of 2000. Although we expect our revenues from America Online to increase in absolute dollar amounts, we also expect these revenues to decline as a percentage of our total revenues as we expand and broaden our revenue base. In December 1999, we extended our strategic relationship with America Online to provide it with additional dial-up as well as broadband backbone Internet services. In December 1999, we agreed to operate the existing dial-up network for AOL Japan, Inc., and we will be responsible for a significant portion of the continued expansion of that network. Our expanded contractual relationship with America Online extends through 2006. You should refer to the section in "Business" entitled "Our Relationship With America Online".

We also include in access revenues those revenues derived from our provision of dedicated Internet access to AT&T for resale to customers of its Business Communications Services Division in the United States. We derived approximately 10% of our total revenues from AT&T in 1997. That percentage decreased to approximately 7% in 1998 and approximately 2% in 1999 because our strategic relationship with AT&T, under which BBN Corporation acted as the exclusive provider for these services, was terminated in September 1997.

Hosting. Our web hosting services provide reliable hosting and a high speed network infrastructure as well as flexible, fast and secure hosting platforms and an experienced technical support staff. Our web hosting services include managed hosting, collocation, content delivery and high availability services. Our hosting revenues are based primarily on monthly fees for server management, physical facilities and bandwidth utilization. Our web hosting services contracts typically range from one to two years.

Transport. We provide a broad range of transport services. These services are generally purchased by telecommunications carriers and Internet service providers requiring additional capacity and do not include Internet access services. Our transport revenues are typically based on available bandwidth. Our transport services contracts typically range from one to two years.

Other. Other revenues include the results of our international business, which consist primarily of Internet access, and domestic value-added e-business services, such as managed security services, virtual private networks for secure data transmission and the transport of voice communications that have been converted to IP, commonly referred to as voice-over-IP. We charge for international access and hosting revenues on a basis consistent with our domestic services. We charge for our security and virtual private network services on a fixed, monthly recurring fee basis and we charge for our voice-over-IP services based on usage. The terms of our value-added e-business service contracts typically range from one to two years.

We believe that our hosting and other revenues will increase substantially as a percentage of our total revenues. We also expect to continue to experience declining prices in our access and transport services in the foreseeable future.

Components of Operating Expenses

Cost of Goods Sold. Cost of goods sold consists primarily of the costs of leasing telecommunications circuits and labor and expenses of operating our network infrastructure. We also include in cost of goods sold the salaries and benefits of our technical, operations and customer service personnel as well as facilities administration, including rent, maintenance and utilities to support our data centers.

We expect our network infrastructure requirements to grow in conjunction with the growth of our overall business and, accordingly, expect our cost of goods sold to increase significantly in the future. We believe our investments in network infrastructure will cause our total data transmission costs to increase substantially in the near term because of higher network operating and maintenance expenses associated with this expansion. Although we expect our total data transmission costs to increase significantly in absolute dollar amounts as we expand, we also expect them to decline as a percentage of revenues in the future as we add and utilize additional capacity and migrate customers from our leased facilities to our own network.

Selling, General and Administrative. Selling, general and administrative expenses consist primarily of salaries and benefits for our marketing, sales and support personnel, advertising, trade shows, professional fees and legal and accounting services and other miscellaneous expenses. We expect selling, general and administrative expenses in the future to increase in absolute dollar amounts as we hire additional personnel, expand our operations, invest in new support systems and incur additional costs related to the growth of our business. More specifically, we expect that advertising expenses will increase substantially in the near term as we launch our advertising and branding campaign and substantially increase our sales force. However, we expect selling, general and administrative expenses to decline as a percentage of revenues.

Depreciation and Amortization. Depreciation and amortization expenses consist primarily of depreciation of our network infrastructure, including data center equipment and related assets, and amortization of our goodwill and other intangible assets. We expect these expenses to increase in the future as we invest significant capital to expand our network infrastructure and data center capacity.

In 1999, we completed the initial build-out of our high speed fiber network infrastructure in the United States and have started adding additional layers of capacity to meet existing and anticipated market demand. Our network infrastructure has over 17,500 route miles of optical fiber connecting over 100 metropolitan areas in the United States. Through our recent investments in undersea fiber optic cable capacity, we have expanded the reach of our network into Europe and Asia.

Basis of Presentation

Our selected combined financial data as of December 31, 1995, 1996, 1997, 1998 and 1999 and March 31, 1999 and 2000 and for each of the five years in the period ended December 31, 1999 and the three months ended March 31, 1999 and 2000 include the financial position and results of operations of those operations that will constitute Genuity as of the completion of this offering. Our combined financial data as of December 31, 1995 and December 31, 1996 and our results of operations for each of the two years in the period ended December 31, 1996 do not include the financial data of BBN Corporation. GTE acquired BBN Corporation effective June 30, 1997. This acquisition was accounted for as a purchase business combination and, consequently, the results of operations of BBN Corporation, excluding the operations of BBN Technologies, which are being retained by GTE, are only included in our results of operations for periods after June 30, 1997. The results of operations of our predecessor represent the results of operations of BBN Corporation, excluding the operations of BBN Technologies.

The following table sets forth our results of operations data derived from our audited financial statements and unaudited financial statements for the three months ended March 31, 1999 and 2000. For the purposes of the following discussion and analysis, the pro forma results of operations for the year ended December 31, 1997 combine the results of operations of our predecessor for the six months ended June 30, 1997 with the results of operations of Genuity for the year ended December 31, 1997, which includes the post-acquisition results of our predecessor effective July 1, 1997. This presentation was included to permit useful and complete year-to-year comparisons between the results of operations for the years ended December 31, 1997, 1998 and 1999. However, this pro forma restated information is not necessarily indicative of the operating results we would have achieved if we had acquired our predecessor on January 1, 1997. The first six months of 1997 did not include some operating expenses, amortization expense and allocations from GTE for centralized corporate services and infrastructure costs, which were included in the second six months of the year.

Results of Operations

	Year Ended December 31,			Three Months Ended March 31,	
	Pro Forma 1997	1998	1999	1999	2000
			(in thousands)		
Revenues	\$ 289,801	\$ 446,002	\$ 706,466	\$ 157,283	\$ 247,852
Operating expenses:					
Cost of goods sold	258,710	492,794	767,498	160,540	283,928
Selling, general and administrative	181,763	312,916	396,522	93,123	108,336
Depreciation and amortization	59,980	104,444	187,628	41,092	53,786
Total operating expenses	500,453	910,154	1,351,648	294,755	446,050
Operating loss	(210,652)	(464,152)	(645,182)	(137,472)	(198,198)
Other income (expense)					
Interest expense, net	(1,824)	(20)	(183)	(434)	(2,973)
Other, net	318	(2,924)	(32)	(341)	(8,067)
Loss before income taxes	(212,158)	(467,096)	(645,397)	(138,247)	(209,238)
Income taxes	433	1,463	1,649	333	588
Net loss	<u><u>\$(212,591)</u></u>	<u><u>\$(468,559)</u></u>	<u><u>\$ (647,046)</u></u>	<u><u>\$(138,580)</u></u>	<u><u>\$(209,826)</u></u>

The following table sets forth our results of operations data, including the pro forma data for 1997, expressed as a percentage of total revenues, for the periods indicated.

	Year Ended December 31,			Three Months Ended March 31,	
	Pro Forma 1997	1998	1999	1999	2000
Revenues	100%	100%	100%	100%	100%
Operating expenses:					
Cost of goods sold	89	110	109	102	115
Selling, general and administrative	63	70	56	59	44
Depreciation and amortization	21	23	27	26	22
Total operating expenses	173	203	192	187	181
Operating loss	(73)	(103)	(92)	(87)	(81)
Other income (expense)					
Interest expense, net	(1)	—	—	—	(1)
Other, net	—	(1)	—	—	(3)
Loss before income taxes	(74)	(104)	(92)	(87)	(85)
Income taxes	—	—	—	—	—
Net loss	<u>(74)%</u>	<u>(104)%</u>	<u>(92)%</u>	<u>(87)%</u>	<u>(85)%</u>

Three Months Ended March 31, 2000 Compared to Three Months Ended March 31, 1999

Revenues

	Three Months Ended March 31,			
	1999		2000	
	Amount	%	Amount	%
(dollars in thousands)				
Access	\$128,038	81%	\$183,285	74%
Hosting	10,028	6	21,692	9
Transport	13,535	9	23,625	9
Other	5,682	4	19,250	8
Total	<u>\$157,283</u>	<u>100%</u>	<u>\$247,852</u>	<u>100%</u>

Our revenues in the first quarter of 2000 increased \$91 million, or 58%, over the first quarter of 1999. The first quarter of 1999 included approximately \$11 million of revenues associated with our strategic relationship with AT&T. This contract has been terminated. If we exclude those revenues from the first quarter of 1999, total revenues increased 70%.

Access. Our access revenues in the first quarter of 2000 increased \$55 million, or 43%, over the first quarter of 1999. The increase in access revenues reflects an 80% increase in dial-up access modems deployed and a 24% increase in dedicated access customers. These increases were offset in part by lower prices, including the pricing structure associated with our new contract with America Online.

Hosting. Our hosting revenues in the first quarter of 2000 increased \$12 million, or 116%, over the first quarter of 1999, due to an increase in the number of our managed hosting customers.

Transport. Our transport revenues in the first quarter of 2000 increased \$10 million, or 75%, over the first quarter of 1999 due primarily to the increased sale of private line services.

Other. Other revenues in the first quarter of 2000 increased \$14 million, or 239%, over the first quarter of 1999 due to a \$5 million increase in sales of Internet access services in international markets and an \$8 million increase in value-added e-business services.

Operating Expenses

Costs of Goods Sold. Our cost of goods sold in the first quarter of 2000 increased \$123 million, or 77%, over the first quarter of 1999. The increase was the result of the continued build out of our network infrastructure to provide access to a broader base of customers, support a growing customer base and provide increased scope to service customers of our Internet access services. Cost of goods sold, as a percentage of total revenues, was 115% in the first quarter of 2000 compared to 102% in the first quarter of 1999. The new pricing structure associated with the America Online contract contributed to the increase.

Selling, General and Administrative Expenses. Our selling, general and administrative expenses in the first quarter of 2000 increased \$15 million, or 16%, over the first quarter of 1999. This increase is attributable to costs associated with the expansion of our sales force and our marketing organization.

Depreciation and Amortization. Our depreciation and amortization in the first quarter of 2000 increased \$13 million, or 31%, over the first quarter of 1999. The increase is the result of capital expenditures associated with the continued build out of our network infrastructure.

Net Loss

Our net loss increased to \$210 million in the first quarter of 2000 compared to \$139 million in the first quarter of 1999. We expect to continue to incur significant net losses over the next several years, given our planned operating and capital expenditures.

1999 Compared to 1998 and 1998 Compared to 1997

Revenues

	Year Ended December 31,					
	Pro Forma 1997		1998		1999	
	Amount	%	Amount	%	Amount	%
	(dollars in thousands)					
Access	\$222,964	77%	\$350,777	79%	\$555,603	79%
Hosting	19,291	7	33,469	8	48,811	7
Transport	41,920	14	46,876	10	64,483	9
Other	5,626	2	14,880	3	37,569	5
Total	<u>\$289,801</u>	<u>100%</u>	<u>\$446,002</u>	<u>100%</u>	<u>\$706,466</u>	<u>100%</u>

Our revenues for 1999 increased \$260 million, or 58%, over 1998. Our revenues for 1998 increased \$156 million, or 54%, over 1997.

Access. Our access revenues in 1999 increased \$205 million, or 58%, over 1998. Our access revenues in 1998 increased \$128 million, or 57%, over 1997. These increases were due to an 87% increase in 1999 and a 76% increase in 1998 in the number of dial-up access modems deployed, primarily resulting from our expanded relationship with America Online, and to a lesser extent, an increase in the number of dedicated access customers. These increases were, in each year, offset in part by lower prices.

Hosting. Our hosting revenues in 1999 increased \$15 million, or 46%, over 1998, due to a 23% increase in the number of our managed hosting customers. Our hosting revenues in 1998 increased \$14 million, or 73%, over 1997 due in large part to our acquisition of a web hosting company in December 1997.

Transport. Our transport revenues in 1999 increased \$18 million, or 38%, over 1998, due to the sale of excess capacity on our network as we brought new network segments on line. Our transport revenues in 1998 increased \$5 million, or 12%, due to increased sale of private line services.

Other. Other revenues in 1999 increased \$23 million, or 152%, over 1998 due to an \$18 million increase in sales of Internet access services in international markets and a \$4 million increase in sales of voice-over-IP and managed security services. Other revenues in 1998 increased \$9 million, or 164%, over 1997, due to a \$5 million increase in international revenues and a \$3 million increase in sales of managed security services.

Operating Expenses

Cost of Goods Sold. Our cost of goods sold in 1999 increased \$275 million, or 56%, over 1998, and our cost of goods sold in 1998 increased \$234 million, or 90%, over 1997. Our cost of goods sold, in each case, increased as a result of the build-out of our network infrastructure to provide access to a broader base of customers, support a growing customer base and provide increased scope to service customers of our Internet access services. Our continued expansion of the dial-up network operated for America Online also contributed to the increase in cost of goods sold in 1999.

Our cost of goods sold, as a percentage of total revenues, was 89% in 1997, 110% in 1998 and 109% in 1999. To the extent we are able to increase our base of customers and correspondingly increase our revenues, we expect cost of goods sold to decrease as a percentage of our total revenues. Our telecommunications circuit costs represent a substantial percentage of cost of goods sold. These costs, which largely relate to long haul circuits, are expected to decrease as a percentage of our revenues as we migrate customers from our leased facilities to our own network.

Selling, General and Administrative Expenses. Our selling, general and administrative expenses in 1999 increased \$84 million, or 27%, over 1998. This increase was due to a \$67 million increase in selling expenses that were directly attributable to an increase in the number of sales and sales-related employees, both domestically and internationally. The growth in our sales force resulted in higher training expenses and additional costs for expansion of field offices. Also contributing to this increase was a \$17 million increase in general and administrative expense resulting from the hiring of additional management staff and related operating expenses, increased facilities costs and increased information technology expenses.

Our selling, general and administrative expenses in 1998 increased \$131 million, or 72%, over 1997. Selling expenses increased \$45 million due to customer growth, higher new product development costs and investment in our sales and marketing infrastructure, including expansion of sales channels, advertising costs and other promotional activities related primarily to Internet-based services for enterprise and service providers. General and administrative expenses increased \$86 million due to increases in management staff and related operating expenses across the organization, as well as increased cost of Year 2000 renovation and system testing.

Depreciation and Amortization. Our depreciation and amortization expenses in 1999 increased \$83 million, or 80%, over 1998. This increase reflects our continuing investment in our network infrastructure in order to support our growth in customers and services. At December 31, 1999, over 17,500 miles of our fiber optic network were operational and, therefore, being depreciated.

Our depreciation and amortization increased \$44 million, or 74%, in 1998 over 1997. The increase reflects the continuing investment in our network infrastructure, which had over 5,900 miles of fiber deployed and operational and, therefore, being depreciated. In 1998 we also had a full year of amortization of goodwill related to two acquisitions in 1997, compared to a half year of amortization expense in 1997.

Net Loss

Our net losses increased to \$647 million in 1999 compared to \$469 million in 1998 and \$213 million in 1997. Our net losses increased to \$210 million in the first quarter 2000 compared to the first quarter 1999. Given our planned operating and capital expenditures, we expect to continue to incur significant net losses over the next several years.

Income Taxes

Our tax provision was computed on a stand-alone basis. Since July 1, 1997, our federal income tax returns have been filed on a consolidated basis with GTE. We generated taxable losses of \$115 million in 1997, \$527 million in 1998, \$638 million in 1999 and \$179 million in the first quarter of 2000, which were benefited by GTE in its consolidated income tax return. We received reimbursements for these tax benefits of \$40 million, \$186 million and \$224 million for the years ended December 31, 1997, 1998 and 1999 and \$62.5 million for the three-month period ended March 31, 2000. To reflect our income tax provision on a basis that will be comparable to future periods, these reimbursements have been accounted for as capital contributions. Our tax provision represents amounts owed for state taxes. Our ability to use net operating losses may be subject to annual limitations. We may also pay income taxes in the future due to operating income in some states and foreign countries. In the future, if we achieve operating profits and the net operating losses have been exhausted or have expired, we may experience significant tax expense.

Quarterly Results of Operations

The following table sets forth our unaudited quarterly results of operations data for each of the nine quarters in the period ended March 31, 2000. This data has been derived from our unaudited combined financial statements. We believe that this information has been prepared on the same basis as our audited combined financial statements and that all necessary adjustments, consisting only of normal recurring adjustments, have been included to present fairly the selected quarterly information when read in conjunction with our audited combined financial statements and accompanying notes included elsewhere in the prospectus. The operating results for any particular quarter are not necessarily indicative of the operating results for any future period.

	Three Months Ended								
	Mar. 31, 1998	June 30, 1998	Sep. 30, 1998	Dec. 31, 1998	Mar. 31, 1999	June 30, 1999	Sep. 30, 1999	Dec. 31, 1999	Mar. 31, 2000
	(in thousands)								
Revenues	\$ 96,863	\$ 109,731	\$ 115,018	\$ 124,390	\$ 157,283	\$ 165,545	\$ 181,548	\$ 202,090	\$ 247,852
Operating expenses:									
Cost of goods sold	101,397	118,173	127,613	145,611	160,540	178,856	206,260	221,842	283,928
Selling, general and administrative . .	78,009	77,493	75,539	81,875	93,123	94,178	97,970	111,251	108,336
Depreciation and amortization . . .	21,071	23,272	28,071	32,030	41,092	44,148	49,831	52,557	53,786
Total operating expenses	200,477	218,938	231,223	259,516	294,755	317,182	354,061	385,650	446,050
Operating loss	(103,614)	(109,207)	(116,205)	(135,126)	(137,472)	(151,637)	(172,513)	(183,560)	(198,198)
Other income (expense):									
Interest income (expense), net . .	(340)	200	2,115	(1,995)	(434)	391	948	(1,088)	(2,973)
Other, net	(152)	(377)	(219)	(2,176)	(341)	(1,714)	(336)	2,359	(8,067)
Loss before income taxes	(104,106)	(109,384)	(114,309)	(139,297)	(138,247)	(152,960)	(171,901)	(182,289)	(209,238)
Income taxes	326	343	358	436	333	369	463	484	588
Net loss	<u>\$(104,432)</u>	<u>\$(109,727)</u>	<u>\$(114,667)</u>	<u>\$(139,733)</u>	<u>\$(138,580)</u>	<u>\$(153,329)</u>	<u>\$(172,364)</u>	<u>\$(182,773)</u>	<u>\$(209,826)</u>

Liquidity and Capital Resources

We have used cash in our operating and investing activities during all periods. We have funded these cash requirements principally through permanent contributions to capital from GTE and borrowings from its affiliates. Capital contributions amounted to \$611 million in 1997, \$1.3 billion in 1998, \$974 million in 1999 and \$488 million in the first quarter of 2000. We expect to continue to fund all of our cash requirements prior to this offering through permanent contributions of capital from GTE.

Net cash used in operating activities was \$91 million in 1997, \$513 million in 1998 and \$404 million in 1999. Net cash used in operating activities was \$119 million in the first quarter of 2000. Net cash used in operating activities for these years and the three-month period was primarily the result of operating losses.

Net cash used in investing activities was \$774 million in 1997, \$505 million in 1998 and \$701 million in 1999. Net cash used in investing activities in each of these years was primarily the result of capital expenditures for construction of our network infrastructure, as well as leasehold improvements, furniture, fixtures, computers and other equipment. Our capital expenditures for the three-year period ended December 31, 1999 totaled over \$1.4 billion. Our net cash for investing activities in 1997 included the acquisitions of BBN Corporation, our predecessor, and a web hosting company, which together totaled \$518 million. Net cash used in investing activities was \$212 million for the first quarter of 2000 due primarily to the result of capital expenditures for the continued construction of our network infrastructure. Our capital expenditures in the first quarter of 2000 were \$211 million.

We currently intend to spend approximately \$1.8 billion to \$2.0 billion during the year ended December 31, 2000 on capital expenditures, of which approximately \$1.2 billion is expected to be spent on the continued expansion of our fiber optic network and approximately \$250 million is expected to be spent on the construction of additional data centers. As of March 31, 2000, we had entered into \$401 million in commitments for these projected expenditures.

Our capital expenditures program, as currently contemplated, will require between \$11 billion and \$13 billion over the five-year period ending December 31, 2004, the majority of which will be for the expansion of our network infrastructure. We expect capital expenditures to continue to increase significantly beyond this period, depending on the pace at which we build and expand our network infrastructure and increase our employee base to support our operations and invest in our selling and marketing organization. In the near term, we believe that the proceeds from this offering, along with the capital contribution from GTE prior to this offering that will offset intercompany debt as well as any outstanding external debt as of the closing of the offering, should be sufficient to meet our cash needs through the first quarter of 2001.

Our future cash requirements, however, will depend on a number of factors, including:

- the pace at which we expand our network infrastructure and the associated costs;
- the rate at which customers purchase our services and the pricing of those services;
- the level of marketing required to build our brand, to acquire and retain customers and to maintain a competitive position in the marketplace;
- the rate at which we invest in support systems and engineering; and
- investment opportunities in complementary businesses or technologies.

We will be required to raise additional capital to fund our business plan as currently contemplated. We cannot predict the timing and exact amount of capital that we will be required to raise. We expect to raise this capital principally through public offerings or private placements of debt or equity securities, depending on market conditions. The issuance of additional equity would be dilutive to the holders of our Class A common stock. We are required to obtain the consent of Verizon or other future holders of our Class B common stock

prior to issuing shares of our capital stock in excess of specified limits and our agreement with Verizon limits our ability to incur debt in excess of agreed upon amounts. You should refer to “Description of Capital Stock” and the section in “Related Party Transactions” entitled “Recapitalization Agreement” for more information regarding limitations imposed on us by our charter and contractual relationship with Verizon. If we are unable to obtain required additional capital through the issuance of these securities or are required to obtain it on terms less satisfactory than we desire, we may be required to delay the expansion of our business.

As of March 31, 2000, our indebtedness included \$49 million of 6% convertible subordinated debentures. These debentures are due in 2012 and may be converted at any time by the bondholders into cash at an exchange ratio of \$966.67 for each \$1,000 in principal amount of debentures. The debentures are unsecured obligations of Genuity and are subordinated in right of payment to our senior indebtedness, if any. We are required to contribute to a sinking fund annual payments equal to 5% of the aggregate principal amount issued. As of December 31, 1999, we had purchased and retired debentures with an aggregate principal of \$37.3 million, which satisfies the annual sinking fund requirements through 2006.

As of March 31, 2000, our indebtedness also included \$83 million in capital leases. The capital leases bear interest at 5.07% to 9.50% and have terms of 5 years from the date of purchase, with principal and interest payable quarterly in advance.

In addition, in the future we may wish to selectively pursue possible strategic investments in businesses, technologies or products complementary to ours in order to expand our geographic presence and achieve operating efficiencies. We may not have sufficient liquidity, or we may be unable to obtain additional debt or equity financing on favorable terms or at all, to finance these investments.

Year 2000

We do not believe that the Year 2000 rollover has had, or will have, any material adverse impact on our operating results or liquidity. We have not experienced any material contingencies with customers or major suppliers nor have we experienced any significant Year 2000 events. The estimated total cost of our Year 2000 compliance efforts is expected to total approximately \$60 million, of which \$54 million has been expended through March 31, 2000.

Inflation

We do not believe that inflation has had a material adverse impact on our business or operating results during the periods presented.

Recently Issued Accounting Pronouncements

The Securities and Exchange Commission issued Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition in Financial Statements, on December 3, 1999. We are required to adopt this new accounting guidance, as amended by SAB No. 101A, no later than the second quarter of 2000. We implemented this accounting guidance in the first quarter of 2000.

In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 133, “Accounting for Derivative Instruments and Hedging Activities”. SFAS No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities. SFAS No. 133, as amended by SFAS No. 137, is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. This new standard is not anticipated to have an impact on our combined financial statements based on our current structure and operations.

Quantitative and Qualitative Disclosure About Market Risk

While our long-term debt bears fixed interest rates, the fair value of our fixed rate long-term debt is sensitive to changes in interest rates. There is a risk that market rates will increase and the required payments will exceed those based on the current market rates. The estimated fair value of long-term debt based on a debt pricing model was lower than its recorded value by approximately \$1.2 million as of December 31, 1998, by approximately \$6.6 million as of December 31, 1999 and by approximately \$6.8 million as of March 31, 2000. Under our current risk management policies, we do not use interest rate derivative instruments to manage our exposure to interest rate changes.

BUSINESS

Overview

We are a leading e-business network provider of high quality, managed Internet infrastructure services to enterprises and service providers. We use the term e-business to refer to commercial transactions conducted over the Internet. We offer a comprehensive suite of managed Internet infrastructure services, including:

- Internet access through dial-up, dedicated and digital subscriber lines;
- web hosting and content delivery; and
- value-added e-business services, such as virtual private networks for secure data transmissions and security services.

We operate a state-of-the-art global network that consists of:

- recently deployed broadband fiber optic cable in the United States;
- points of presence, which are locations where we provide Internet access to end users;
- secure data centers with redundant fiber connections to our network and backup power sources; and
- undersea and international fiber optic cable capacity.

Our large base of on-network users and content, combined with our extensive network, positions us as one of the leading Internet backbone providers in the world, a status commonly referred to as a Tier 1 Internet backbone provider. Tier 1 Internet backbone providers have the network scale and on-network traffic to offer their customers connectivity to virtually all addresses on the Internet either directly through their Internet backbone or through cost-free, high speed private connections to other Tier 1 Internet backbones. We believe that service providers are increasingly connecting to networks with substantial on-network content to improve the quality of their customers' experience, which in turn drives demand by enterprises seeking to connect to networks with large numbers of users. We believe that by taking advantage of this demand cycle, which we call the "network effect", we will continue to drive significant demand for our services from both enterprises and service providers and differentiate ourselves from non-Tier 1 Internet backbone providers.

Industry Background

The Growing Importance of the Internet

The Internet has experienced tremendous growth in the past decade and has emerged as an important global medium for communications and commerce. The growth in data that is transmitted over the Internet is driven by a number of factors, including the rapidly increasing number of network-enabled and Internet-based applications, the growing number of personal computers linked to the Internet, advances in network-enabled devices, servers and routers and the increasing availability of broadband connections.

The explosive growth of the Internet and the increasing demand for data services are expected to continue. According to International Data Corporation, the number of Internet users worldwide will increase from 142 million at the end of 1998 to approximately 502 million by the end of 2003. In addition, according to International Data Corporation, the number of web pages is expected to grow from 1.7 billion in 1999 to approximately 13.1 billion in 2003. This growth is expected to lead to a substantial increase in the demand for bandwidth and other Internet infrastructure services.

The proliferation of the Internet within the business environment, in particular, has been substantial. Once primarily used for e-mail and retrieving information, the Internet is now being used as a communications platform for an increasing number of mission-critical Internet-based applications, such as those relating to

e-commerce, internal networks or intranets, telephone and facsimile capabilities, supply chain management, customer service and project coordination via extranets. The Gartner Group estimates that worldwide business-to-business e-commerce sales will grow from \$145 billion in 1999 to approximately \$7.3 trillion in 2004.

To improve the effectiveness and scalability, of their critical Internet-based applications, both enterprises and service providers are requiring increasing levels of network performance, including capacity, reliability, security and manageability, across the Internet.

The Growing Demand for Outsourced Internet Infrastructure Solutions

As the Internet and data traffic have grown, the cost and complexity for enterprises and service providers to manage their own network infrastructure demands in-house has increased. Traditionally, enterprises were required to make substantial investments in developing the Internet expertise and infrastructure necessary to ensure the quality, reliability, security and availability of their Internet operations. The implementation and maintenance of Internet infrastructure solutions also require significant technical expertise and capital expenditures in a number of other areas, such as e-commerce systems, security and privacy technologies, advanced user interface and multimedia production. Moreover, the information technology departments within enterprises are constantly challenged by the need to implement their Internet business strategy, adopt new and rapidly changing technologies, transition to new broadband content applications and continuously update dynamically changing content. As a result, enterprises are seeking Internet infrastructure service providers that can minimize their exposure to the capital, human and technological risks associated with in-house solutions. To increase their competitive edge, enterprises are now outsourcing their critical Internet operations to increase performance and scalability, speed time-to-market and reduce costs.

Similarly, service providers are challenged by the rapid growth and increasing complexity of the Internet infrastructure, the dramatic increase in data traffic and the growing need to meet the demands of broadband applications. Service providers are increasingly required to devote substantial capital and human resources to expanding the capacity and the technological capabilities of their networks. As the demands of their customer base grow, these service providers find it more difficult to quickly, cost-effectively and efficiently deliver service through internal infrastructure expansion. As a result, service providers are increasingly focusing their resources on sales and marketing and outsourcing their Internet infrastructure requirements to organizations focused on developing and enhancing a high capacity Internet infrastructure that can be quickly expanded to meet their requirements.

The Development of the Internet Infrastructure Services Market

The growing demand from enterprises and service providers for outsourced Internet infrastructure services has led to the development of an Internet infrastructure service market comprised of companies focused on solving these outsourcing requirements. Many of these companies have endeavored to build or otherwise acquire network facilities in order to provide Internet access, while others have addressed more specific solutions, such as web hosting or security services. According to Forrester Research, the Internet access and web hosting markets in the United States are expected to grow from an aggregate of \$4 billion in 1998 to \$57 billion by 2003, representing a compound annual growth rate of approximately 70%.

Enterprises and service providers are increasingly demanding Internet infrastructure service providers that can deliver a high quality Internet experience for their users. The ability to deliver this high quality experience has become more difficult, largely as a result of an increasing number of Internet users and richer content, including graphics, photographs and streaming video and audio. In addition, as the number of networks connected to the Internet has grown, the delay and loss of data that is transmitted over the Internet has increased. This is particularly true at the major public peering points where multiple Internet service providers exchange data over shared facilities. To increase performance, a number of Internet backbone providers have established high-speed private connections with other networks to exchange traffic over dedicated fiber circuits.

These connections are referred to as private peering connections. The quality of an experience on the Internet is therefore highly dependent on the quality, capacity and reliability of the physical facilities over which Internet services are provisioned and the Internet backbone through which Internet access is provided and content is delivered.

The critical elements of delivering a high quality user experience are a large base of on-network users, content, and high speed, well-managed private peering relationships with other Tier 1 Internet backbones. Internet backbone providers that have these competitive strengths are able to route traffic to virtually all Internet addresses and avoid the need to route traffic across multiple networks and congested public peering points. Consequently, their users encounter fewer delays due to transmission bottlenecks across public peering points, and enterprise and service providers using these Internet infrastructure service providers are better able to manage the quality of experience of their end users.

Accordingly, enterprises and service providers increasingly look to the limited number of providers that offer a comprehensive suite of managed Internet infrastructure services, a large base of on-network users and content, and reliable and scalable network facilities. We believe that we are among only a few companies in the world that offer the full complement of these attributes as part of their e-business network solution.

Our Solution

Our e-business network solution enables our customers to outsource their Internet infrastructure needs to a single provider and to scale their Internet operations in a cost-effective and reliable manner. The key elements of our solution include:

Comprehensive Suite of Managed Internet Infrastructure Services. We offer a broad range of managed Internet infrastructure services, including: Internet access; web hosting and content delivery; and value-added e-business services, such as virtual private networks for secure data transmission, security services and voice-over-IP. Our services are designed to enable customers to purchase the level of service, features, access speed and functionality that meet their existing requirements, while at the same time allowing them to easily upgrade services over time. We believe there is significant opportunity to offer integrated services to enterprise customers as their requirements evolve from Internet connectivity to more critical Internet applications. As part of our solution, we install, configure, maintain and monitor industry-leading hardware and software, offer technical consulting and support, provide high-volume backup and recovery systems and monitor our Internet backbone operations 24 hours a day, seven days a week. Additionally, we provide flexible service pricing that allows our customers to be billed according to their bandwidth and capacity utilization.

Large Base of On-Network Users and Content. Because we provide Internet access services to many of the leading Internet service providers, including America Online, Earthlink, NetZero and Web TV, web hosting services for popular web sites as Yahoo! and ZDNet, and high speed connections to enterprises that host their own web sites, such as Microsoft, we carry a significant amount of traffic over our Tier 1 Internet backbone. We believe enterprises and service providers choose to connect to our Internet backbone because they can directly route traffic to, or receive content from, a significant number of other customers on our network. This capability results in higher transmission speeds, lower instances of data loss and greater quality of service, thereby improving the overall quality of experience for Internet users. We believe that service providers are increasingly connecting to networks with substantial on-network content to improve the quality of their customers' experience, which in turn drives demand by enterprises seeking to connect to networks with large numbers of users. We believe that by taking advantage of this demand cycle, which we call the "network effect", we will continue to drive significant demand for our services from both enterprises and service providers and differentiate ourselves from non-Tier 1 Internet infrastructure service providers.

State-of-the-Art Network. We operate a state-of-the-art, high capacity global fiber optic network that is highly reliable and scalable. Over 85% of our fiber has been deployed within the past two years, and a majority

of our optical electronic equipment has been installed within the past year. Our highly redundant fiber optic network architecture is designed to minimize service interruptions in our network operations. We have significant additional capacity on our fiber network, which already carries a substantial portion of our traffic. This capacity allows us to scale quickly at favorable incremental capital costs as we meet increased customer demands and continue our transition from leased capacity. We also operate eight data centers in the United States, one data center in the United Kingdom and one in Japan, through which we provide managed and collocated web hosting services for enterprises with critical Internet operations. Through our technologically advanced data centers, we offer customers a secure environment to house critical Internet operations and to obtain high bandwidth connectivity to the Internet.

High Performance, Tier 1 Internet Connectivity. We provide high performance connectivity to the Internet through our Tier 1 Internet backbone and extensive high speed private connections to other major Internet backbone providers and, to a lesser extent, public peering points. Our extensive private peering relationships permit us to have direct, cost-free exchange of traffic with a significant number of telecommunications carriers and Internet infrastructure service providers, thus avoiding the congestion of public peering points when directing traffic to users connected to those Internet backbones. As a result, we are able to offer our customers direct access to our on-network users and content. In addition, over 80% of the traffic we deliver to the rest of the Internet is delivered through private peering connections.

Significant Internet Protocol Engineering and Architectural Expertise. Drawing upon the breadth and depth of our IP and networking experience and expertise, including over 750 engineers and over 1,100 technicians, we are able to quickly and cost-effectively identify the Internet infrastructure requirements of our customers and design and implement appropriate solutions. For service providers, this entails testing, certifying, deploying and scaling, within our network, the latest fiber optic and IP routing, switching and web hosting technology to provide cost-effective and highly reliable managed Internet infrastructure services. For our enterprise customers, we provide high quality IP solutions comprised of one or more of our services. For example, we combine our Internet access, web hosting, virtual private networks and managed security services to enable secure intranets and extranets for enterprises.

Our Strategy

Our objective is to be the leading e-business network provider by architecting, building and operating the infrastructure for the Internet economy. The principal elements of our strategy for pursuing this objective include:

Leveraging the Network Effect. We intend to continue to target enterprises and service providers with significant Internet infrastructure demands. The addition of an increasing number of service providers enables us to cost-effectively scale our network and attract enterprises that seek to connect to networks with a large number of users. The additional users that these service providers bring to our network attract enterprises that want to market their products and services directly to a larger base of users. We believe that attracting these customers will enhance our position as a leading provider of managed Internet infrastructure services as a result of the consolidation of a growing number of users and large volumes of content on our Tier 1 Internet backbone. We also believe that over time the scale associated with an increasing customer base will also allow us to pursue premium pricing with enterprise customers and minimize operating expenses sometimes associated with private peering connections to other Internet backbones.

Expanding Our Capacity and State-of-the-Art Network. We intend to continue to expand our capacity and state-of-the-art network in advance of the capacity demands of our customers. We plan to do this by accomplishing the following by the end of 2001:

- extending our coverage by deploying up to an additional 4,500 route miles of fiber optic cable serving approximately 120 metropolitan service areas and 11 additional international markets;
- expanding our network capacity in the United States to the equivalent of 10 layers of 10 gigabit capacity each;

- increasing our number of dedicated points of presence to nearly 300 and deploying local fiber rings within selected metropolitan service areas to increase our reach to end users;
- adding seven additional data centers in key locations worldwide to address the growing demands for our web hosting and content delivery services;
- expanding our network collocation facilities to enable our service provider customers to reach new markets quickly and cost-effectively; and
- deploying state-of-the-art optical electronic equipment to maximize the capacity of our fiber network.

Continuing to Build and Own Our Network Facilities. As we expand, both domestically and internationally, we intend to build and own the majority of our network facilities rather than leasing them from other facilities-based providers. We believe that owning our network facilities:

- provides greater control over the performance, reliability and breadth of our managed Internet infrastructure services;
- enables us to increase our capacity more quickly to meet increasing bandwidth demands;
- generates higher gross margins than would be generated through leasing circuits from other facilities-based providers; and
- improves service delivery to customers by reducing reliance on third-party providers.

Expanding Our Distribution Capabilities. We intend to develop and expand our direct sales force and our strategic alliances with other Internet-focused companies in order to expand our distribution capabilities. Currently, we have over 350 persons in our direct sales force, and we intend to substantially increase this sales force by the end of 2001. During the same period, we plan to substantially increase our Electronic Business Consultant organization, which is a group of highly skilled sales consultants that aid our existing and potential customers in designing e-business solutions based on our managed Internet infrastructure services. In addition, through our eP@rtner Program, we have formed alliances with leading web integrators, e-business consultants, interactive agencies and other technology providers. We have formed similar alliances with international Internet service providers through our Net.Alliance program. This program enables these Internet service providers to offer our portfolio of IP-based services to their customers and is designed to allow us to provide our services to private and commercial customers in key European, Pacific Rim and Latin American markets. Our current partners in these programs include, among others, Agency.com, Cambridge Technology Partners, Cisco Systems, Ernst & Young, Hewlett-Packard, IBM, Lante, Microsoft, Nortel Networks and Sapient in the United States, Energis in the United Kingdom and I.NET and Tiscali in Italy. These alliances serve as a valuable, cost-effective channel for marketing our services. We also plan to expand our existing reseller relationships to significantly enhance our distribution capabilities.

Pursuing Strategic Transactions and Alliances. We intend to pursue selective acquisitions that will allow us to quickly and cost-effectively extend our geographic presence and customer base, particularly in international markets. Additionally, we intend to make strategic investments in or enter into joint ventures or alliances with complementary businesses to broaden our market presence or expand our strengths in key services. We believe that successfully pursuing these strategic transactions or alliances will enable us to expand our geographic and service reach and to broaden our Internet infrastructure services for our customers.

Using Our Extensive Internet Protocol and Networking Expertise to Develop New Services. We intend to use our long history of IP and networking expertise to strengthen our reputation as a leader in the development and deployment of innovative Internet infrastructure services. We were one of the first to offer commercially managed web hosting services and managed security services. We plan to continue to develop and introduce innovative services that address the evolving requirements of our enterprise and service provider customers. We are pursuing initiatives such as IP-based voice virtual private networks, enhanced multi-media streaming and

content distribution services and wireless and satellite access services. In addition, we plan to partner with or make investments in innovative Internet start-ups and other organizations to enhance both our access to and incorporation of leading technologies.

Establishing Genuity as a Leading Brand for e-Business Network Services. We intend to establish Genuity as a leading brand for e-business network services worldwide. We plan to increase brand awareness by pursuing an aggressive marketing strategy involving television, radio and print advertising as well as extensive public relations efforts. We will pursue additional marketing campaigns specifically targeted at enterprises and service providers. We also intend to build brand recognition by continuing to work closely with our eP@rtners and Net.Alliance partners to increase our exposure to a broader base of customers.

Our Services

We provide a comprehensive suite of managed Internet infrastructure services targeted to two primary customer groups, enterprises and service providers. Our services fall into the following four categories:

- Internet access;
- web hosting;
- value-added e-business services; and
- transport services.

Our enterprise customers rely on our comprehensive suite of managed Internet infrastructure services to create and implement their e-business strategies. Our service provider customers rely primarily on our Internet access and web hosting services, which enable them to focus on the retail aspects of their business while we provide and manage the underlying scalable infrastructure necessary to deliver services to their customers. We believe our focus on developing and tailoring services to meet the needs of our target customers, as well as the scale and diversity of our services, differentiates us from our competitors.

Internet Access. We offer a variety of Internet access services to our enterprise and service provider customers, including dial-up, dedicated and digital subscriber lines. We also provide a range of customer premise equipment that is necessary to connect to the Internet, including routers, channel service units or data services units, modems, software and other products. Our Internet access services, which accounted for over 77% of our total revenues in 1999, include:

- *Dial-up Access.* Our dial-up access service enables users to connect to the Internet using a local telephone number. Our customers can connect to our Internet backbone through more than 800 local access points in the United States and, through our reseller relationship with iPass, a remote access provider, through approximately 1,500 international local access points in more than 150 countries. DiaLinxSM, which is our remote dial-up access service for enterprises that enables them to provide their mobile professionals, telecommuters, customers and business partners with guaranteed, cost-effective local dial-up access to their intranets and extranets, as well as the Internet, from around the world. Similarly, our DiaLinx ISP service enables Internet service providers to expand their existing dial-up access service without incurring substantial up-front capital costs and ongoing operational expenses. For other Internet service providers and organizations that want to quickly offer their customers a private-label, Internet dial-up access service without incurring up-front and ongoing investments in network infrastructure or the burden of providing back office support, we offer a virtual Internet service provider service, called DiaLinx VISPSM.
- *Dedicated Access.* Our Internet AdvantageSM and ISP DirectSM services connect enterprises and service providers directly to the Internet through a dedicated high speed connection. These services are available throughout the United States and in more than 60 other countries. We offer a broad spectrum of dedicated connection types with flexible pricing structures, as well as comprehensive service level guarantees. We offer dedicated Internet access at speeds ranging from T1, including fractional up to 1.5 megabits per second, to OC-12, which is capable of transmitting data at 622 megabits per second.

- *Digital Subscriber Line Access.* Our digital subscriber line access service enables high speed digital transmission over telephone lines. This service allows an end user to use the telephone while connected to the Internet with only one connection. Unlike dial-up access services, our digital subscriber line access service provides a full-time connection that is “always on”. We currently offer service in 24 major metropolitan service areas throughout the United States, with expansion planned to over 50 major metropolitan service areas, covering over 60% of the United States population, by the end of 2000. Our digital subscriber line access services are available in a wide range of dedicated access speeds, from 144 kilobits per second to 1.5 megabits per second. Our digital subscriber line access services for enterprises are designed to meet the needs of telecommuters, branch offices and small businesses by providing high quality Internet access at speeds faster than dial-up and Integrated Services Digital Network and offered for a fixed monthly fee. In addition, for our service provider customers, we coordinate all activities necessary to provide digital subscriber line access service, including service establishment, network connectivity, bulk billing and second tier technical support.

Web Hosting. Our web hosting services, which accounted for 7% of our total revenues in 1999, enable enterprises and application service providers to outsource the storage and management of their web servers to our special purpose web hosting facilities. Our Enterprise AdvantageSM web hosting service provides reliable web hosting and high speed network infrastructure, flexible, fast, and secure web hosting platforms and experienced technical support staff. We currently operate 10 data centers throughout the world, with eight in the United States, one in Leeds, England and one in Tokyo, Japan. Each data center is located in the same building as, or in close proximity to, our network access points. Our data centers are technologically advanced facilities with redundant, high speed connectivity to the Internet, uninterruptible power supplies, back-up generators, fire suppression, raised computer floors, separate cooling zones, seismically braced racks and high levels of security. Our Enterprise Advantage services include:

- *Managed Web Hosting.* Our managed web hosting service provides fully managed, secure and reliable web hosting capabilities for businesses operating in Windows NT or UNIX environments that want to use our expertise to implement and manage their web site infrastructure. We manage the systems and platforms and also retain ownership of equipment and software.
- *Customer Managed Web Hosting.* Our customer managed web hosting service is designed for enterprises that require administrative control of their web sites but prefer to partner with an experienced, reliable web hosting provider. This service provides our customers with pre-configured server hardware and software, Internet access and the benefit of secure and continuously monitored data centers. Our customers retain full responsibility for the content and administration of their web sites.
- *Collocation Web Hosting.* Our collocation web hosting service is designed for enterprises that seek to own their own equipment and retain full responsibility for management, content and administration of their web sites, but need a secure and scalable hosting facility with high performance connectivity.
- *Content Delivery and High Availability Services.* For customers with high traffic web sites, we also offer optional, high availability services that can increase web site capacity and performance. We currently offer four high availability services:
 - *LoadBalancer.* Our LoadBalancerSM service creates a single web address that represents multiple web servers located in a single data center. These web servers utilize advanced load balancing techniques, based on the number of users seeking access to the web site, to connect users to the web server that will produce the fastest response to their request.
 - *Traffic Distributor.* Our Traffic Distributor service is designed for web sites requiring high reliability and involves hosting web servers in multiple data centers. Enabled by our patent-pending HopscotchTM load distribution technology, this service enhances the experience of an end user by directing their content requests to the web server offering the fastest and most reliable service.

- *Site Replicator.* Site Replicator enhances web site availability by mirroring web site content between multiple servers. Site Replicator copies new files, scripts and web images from the primary server to the other servers within its defined group. Site Replicator is a flexible web data replication tool, using efficient algorithms and intelligent data transfer techniques to minimize overhead and ensure that content on all web servers is synchronized.
- *Site Accelerator.* Site Accelerator replicates web site content on servers throughout our Internet backbone and brings this content geographically closer to our users, a process known as caching. This process reduces web page load times. Because this service is performed in our network, our customers receive the benefits of caching without any capital investment. Site Accelerator splits the task of serving content between the cache servers in our network and the dedicated web site servers. When the content is moved to our cache servers, the dedicated web site servers are freed up, permitting more users and more transactions without sacrificing performance from the perspective of the end user.

Value-added e-Business Services. As enterprises and service providers continue to use the Internet as a business-critical tool, we believe they will increasingly demand a wider range of e-business services to ensure security, enhance productivity, reduce costs and improve service reliability and scalability. Today, we offer a range of value-added e-business services, including:

- *Virtual Private Networks.* With our virtual private network service, we enable an enterprise and its employees, customers, suppliers and business partners to securely send and receive information to and from each other via encrypted dial-up, dedicated, digital subscriber line or cable-modem Internet connections. Our VPN AdvantageSM service is a managed virtual private network service that makes it possible to communicate securely over our Internet backbone and over the Internet from virtually anywhere in the world. With VPN Advantage, our customers benefit from the capabilities of a large, shared IP-based network infrastructure while maintaining the look and feel of their own private corporate network.
- *Managed Security Services.* Our managed security services are scalable and can be customized to our customers' needs and provide a high level of protection for their corporate networks. Our managed security services include monitoring the network perimeters of our enterprise customers, 24 hours a day, seven days a week, and use of firewall management, maintenance and proactive response techniques to ensure the security of access points into their computing infrastructure. Our Site PatrolSM for FireWall-1[®] and our Security AdvantageSM are Internet security services that help to significantly reduce exposure to Internet security threats and firewall breaches. In addition, we offer a vulnerability assessment service, Site ScanSM, that helps enterprises strengthen their network perimeter security by periodically testing for potential weaknesses and generating recommendations for correcting them.
- *Voice-over-Internet Protocol.* Through our suite of voice-over-IP services, including International VoIP DirectSM and ESP DirectSM, we offer low-cost, high-quality voice-over-IP network transport to Internet service providers, Internet telephony service providers, enhanced service providers and telecommunications companies providing voice-over-IP services to their customers. We seek to provide our customers with accelerated time-to-market for their customers through innovative, enhanced solutions enabling voice services such as personal computer-to-phone and personal computer-to-personal computer.

Transport. Our transport services are generally purchased by telecommunications carriers and Internet service providers requiring additional capacity. In delivering these services, we provide a single point of contact for planning, ordering, installing, billing, maintaining and managing the transport services of our customers. Our transport services, which accounted for 12% of our total revenues in 1999, include:

- *ATM Service.* Our asynchronous transfer mode, or ATM, transport service, a form of high speed data transfer, is targeted primarily at carriers and Internet service providers with high bandwidth voice, video and data transmission requirements. We provide ATM connections between one or more

locations. Our ATM transport services provide logical permanent virtual connections, thereby supporting applications that send information at a constant or variable bit rate. We offer a wide range of speeds at one megabit per second increments and match the application needs to the desired amount of bandwidth.

- *Private Line Service.* Our private line service provides dedicated point-to-point transport services through non-switched, non-usage sensitive dedicated facilities. Our private line service is supported over our dedicated Synchronous Optical Network, or SONET, facilities, which results in a highly reliable network. These services are comprised of bandwidth delivered in units of: (1) DS-3, which is capable of transmitting data at 44.736 megabits per second; (2) OC-3, which is capable of transmitting data at 155.520 megabits per second; (3) OC-12, which is capable of transmitting data at 622.080 megabits per second; and (4) OC-48, which is capable of transmitting data at 2.488 gigabits per second.
- *Network Collocation Services.* Our collocation services provide our customers with a physical location to collocate communications equipment at our points of presence. This service allows our service provider customers to expand their market areas without extensive recurring real estate charges, build-out fees and overhead costs.

Our Network

We operate a state-of-the-art, facilities-based global fiber optic network designed specifically for IP technology. We own the core components of our network infrastructure in the United States through indefeasible rights of use, or IRUs, for the underlying fiber optic cable. Within the United States we also lease capacity from third parties to provide service to our customers. We estimate that a majority of our traffic is currently transmitted over this leased capacity. We are in the process of transitioning traffic from leased capacity to our network infrastructure and expect that over 80% of our traffic will travel over our owned network by the end of 2001. We also own undersea capacity through IRUs and lease capacity internationally. Our current network infrastructure consists of:

- over 17,500 route miles of owned inter-city fiber cable in the United States that passes through the largest 100 metropolitan service areas and substantial additional leased capacity;
- undersea capacity to Europe via Atlantic Crossing-1 and to Asia via TPC-5;
- approximately 70 facilities-based points of presence in the United States that provide direct access to our fiber network;
- over 70 dedicated Internet access service delivery points in the United States;
- over 800 local points of presence for dial-up access in the United States and, through our reseller relationship with iPass, an additional 1,500 local access points of presence in more than 150 other countries;
- 10 points of presence in international markets, including Amsterdam, Dublin, Frankfurt, London (2), Milan, Paris, Stockholm, Sydney and Tokyo, with the ability to provide service from over 300 additional points of presence in over 60 countries through leased facilities; and
- eight data centers located in the United States and one each in the United Kingdom and Japan.

We plan to substantially expand our network infrastructure, both domestically and internationally. Through the end of 2001, we plan to:

- extend our coverage by deploying an additional 4,500 route miles of fiber cable serving approximately 120 additional metropolitan service areas in the United States and building local fiber rings in major metropolitan service areas in the United States;
- utilize additional international undersea capacity to: (1) Europe via TAT-14 and FLAG Atlantic; (2) Latin America via Americas II; (3) the Caribbean via ARCOS-I; and (4) Asia via Japan-US cable network;

- expand our network capacity in the United States to the equivalent of 10 layers of 10 gigabit capacity each;
- add more than 25 facilities-based points of presence in the United States that provide direct access to our fiber network;
- add more than 200 additional dedicated Internet access service delivery points in the United States;
- add an additional nine points of presence in key international markets;
- add approximately 800,000 additional modems to our North American dial-up infrastructure and expand our coverage to an additional 300 local markets in North America;
- expand our broadband coverage to 80 metropolitan service areas and surrounding cities in the United States; and
- build seven additional data centers in key locations worldwide, which will increase our existing capacity by approximately 1.2 million square feet.

As we expand our network infrastructure, both domestically and internationally, we intend to primarily build and own our facilities rather than lease them from other facilities-based providers. In addition, we have taken the flexible approach of utilizing multiple fiber providers to ensure higher reliability, quicker deployment of new technology and faster provisioning for our customers. Our network infrastructure has the following characteristics:

High Performance, Reliability and Quality. The geographic reach and state-of-the-art nature of our network enhance our ability to provide a high quality user experience. We have incorporated a variety of technologies in our network to ensure high performance and reliable transmission. These technologies include OC-192, which is capable of transmitting data at 10 gigabits per second, and SONET transmission equipment employing self-healing protection switching. These technologies, combined with our ring-based architecture, increase network reliability and minimize the risk of service outages. In the event of a failure in any segment of our network infrastructure, traffic is automatically rerouted across different fiber strands with virtually no interruption in service. Additionally, our network infrastructure makes extensive use of railroad rights-of-way that typically offer greater protection for the fiber than fiber deployed over other rights-of-way such as highways, telephone poles or overhead power transmission.

Capacity on Demand. We currently have an indefeasible right to use over 17,500 route miles of fiber in the United States, with virtually all of these fiber route miles having 24 separate strands. These fiber route miles, which form the core of our network infrastructure in the United States, were operational at the end of 1999. The majority of the fiber deployed in our network infrastructure is state-of-the-art Lucent True Wave® fiber that supports multiple wavelengths, each running at 10 gigabits per second, thus allowing for more capacity on a single fiber strand. Our fiber network, combined with our network design, enables us to take advantage of the most recent advances in optical electronic transmission equipment. For example, we generally are using only four of our existing 24 strands of fiber, each of which supports up to eight wavelengths per fiber at 10 gigabits per second data transmission using current generation optical electronic transmission equipment. However, as optical electronic transmission equipment providing 16, 32, 50 or even higher numbers of wavelengths per fiber becomes commercially available, we plan to deploy this equipment as needed on unused fiber strands to expand the capacity of our network infrastructure. With the advanced nature of our fiber network and the advances in optical electronic transmission equipment, we believe we will have sufficient capacity on our existing fiber in the United States for the foreseeable future. In addition to our owned facilities, we supplement our existing route miles with leased capacity from other providers.

Advanced Network Architectures. We believe that owning our network allows us to implement new network architectures as they become technologically feasible. For example, IP over dense wave division multiplexing, which is an optical technology that increases the amount of data that can be transmitted over a single fiber by dividing that fiber into multiple lightpaths or wavelengths, will eliminate the need for the SONET network layer by relying on IP routers and the dense wave division multiplexing equipment to perform the re-routing that SONET currently performs. Furthermore, advanced optical networking transmission

equipment will enable traffic to be switched and routed without being converted to an electrical signal first. We believe our engineering and architectural expertise will enable us to quickly deploy these new architectures and technologies, thereby reducing the complexity of data systems, increasing flexibility and reducing costs.

Flexible Platform for Multiple Services. Our network has been specifically designed for IP and can carry any form of packet data, including voice, video and traditional data services. While many carriers and service providers use multiple networks and platforms to deliver these distinct services, our IP-optimized network provides a single platform that simplifies network management, customer support and service delivery. In addition, ownership of our facilities enables us to deploy new or enhanced services more quickly. For example, we designed and deployed one of the first architectures to transmit real-time voice and data packets with reliability and performance substantially equivalent to the public switched telephone network. Moreover, our architecture allows for rapid scalability of capacity, quick geographic expansion and cost-efficient implementation of new services and features.

Our Data Centers

We currently operate 10 data centers that have been specifically designed for managed web and application hosting services and high capacity connectivity to our network. We have eight data centers in the United States, located in Palo Alto, California; San Jose, California; Los Angeles, California; Phoenix, Arizona; Chicago, Illinois; Cambridge, Massachusetts; Chantilly, Virginia; and New York, New York. We also have one data center in each of Leeds, England, and Tokyo, Japan.

Our data centers are strategically located in the same building, or in close proximity to, network access points, and all are directly connected to our Internet backbone. Our data centers are technologically advanced facilities with:

- redundant, high speed connectivity to the Internet;
- uninterruptible power supplies;
- back-up generators;
- fire suppression;
- computer floors;
- separate cooling zones;
- seismically braced racks; and
- high levels of physical and network security.

Our highly trained staff monitors these systems 24 hours a day and seven days a week. By the end of 2001, we plan to add seven data centers, adding approximately 1.2 million square feet of additional capacity. Each of these new data centers will be directly connected to our network and will be designed specifically for mission-critical servers with complete redundancy of all support systems. We expect these seven new data centers will be located in: Los Angeles, California; Mountain View, California; Atlanta, Georgia; Cambridge, Massachusetts; Carteret, New Jersey; Chicago, Illinois; and Chantilly, Virginia.

Our International Operations

We provide global coverage for our international customers. Today, we lease our network facilities in international markets, including back haul services from over 300 local points of presence in 60 countries and a SONET fiber ring connecting London, Paris, Frankfurt and Amsterdam, which is capable of transmitting data at 155.520 megabits per second. We are able to provide dedicated access services in more than 60 countries and enable global dial-up access service in more than 150 countries. We provide web hosting services out of our data centers in the United Kingdom and Japan and we have the capability to provide managed security and virtual private network services in over 39 countries. We have 10 points of presence in international markets, including: Amsterdam; Dublin; Frankfurt; London (2); Milan; Paris; Stockholm; Sydney; and Tokyo. All of our international points of presence are capable of accepting voice-over-IP traffic for delivery in the United States.

By the end of 2000, we plan to add nine additional points of presence in the following locations: Manchester; Madrid; Dusseldorf; Hamburg; Hong Kong; Sao Paulo; Rio de Janeiro; San Juan; and Mexico City.

By the end of 2000, we also plan to deploy one of the first OC-48 fiber rings in Europe employing IP over dense wave division multiplexing. We believe this fiber ring network connecting London, Amsterdam, Frankfurt and Paris will dramatically improve our ability to provide high-end data services and is required to meet our rapidly growing traffic in Europe.

GTE has granted the exclusive right to our existing trademarks and proprietary technology to TELUS Corporation for use solely in Canada for the provision of telecommunications services, including Internet services. The TELUS agreement limits our ability to provide Internet services in Canada. We are currently negotiating an arrangement with TELUS that would govern our relationship after this offering when we are not an affiliate of GTE.

In terms of trans-oceanic capacity, over the past two years we have entered into a number of agreements for indefeasible rights of use to cable systems that are either deployed or in the process of deployment. The following table details our current and planned international cable capacity. The expected dates of deployment represent approximate time frames in which we believe our capacity on this cable will become operational. These dates are, to a large extent, beyond our control and deployment may occur significantly later than we expect.

Cable System	Capacity	Terms	Expected Deployment
Americas II	U.S.-Brazil (One STM-1)(1) U.S.-Venezuela (One STM-1) U.S.-Puerto Rico (One DS-3)(2)	25 Years (IRU)	Q3 2000
Atlantic Crossing-1	U.S.-United Kingdom (Two STM-1s) U.S.-Germany (One STM-1) United Kingdom-Netherlands (One STM-1) United Kingdom-Germany (One STM-1)	25 Years (IRU) Lease Lease Lease	In Service
Japan-U.S. Cable Network	U.S.-Japan (Six STM-1s) U.S.-Hawaii (One STM-1) Upgrade Capability to 28.5 STM-1s	25 Years (IRU)	Q4 2000
TAT-14	U.S.-France-Netherlands-Germany-Denmark-U.S. (30 STM-1s)	25 Years (IRU)	Q1 2001
FLAG Atlantic-1	U.S.-United Kingdom-France-U.S. Portable Capacity Seven STM-1s Initially Upgrade Capability to over 50 STM-1s	25 Years (IRU)	Q2 2001
ARCOS-1	U.S.-Caribbean Portable Capacity, Two STM-1s Initially Upgrade Capability to 21 STM-1s	25 Years (IRU)	Q1 2001
TPC-5	U.S.-Japan (One DS-3)	Lease	In Service

(1) STM-1 is capable of transmitting data at 155.520 megabits per second.

(2) DS-3 is capable of transmitting data at 44.736 megabits per second.

Research and Development

We believe that the task of building an Internet infrastructure services business is primarily one of integrating third-party systems, technologies, communications equipment, software and services to provide reliable, highly scalable and cost-effective Internet infrastructure services. Therefore, we generally use commercially available equipment. Our 30 years of IP and networking experience and expertise not only enables us to assess the technology and quality of potential vendors and to assist them in making their products more responsive to the needs of our customers.

We continually monitor research developments in the various industries supporting our business. We work closely with the engineering groups of our existing vendors, technology partners, innovative start-up companies and complementary service providers to incorporate advanced technology, features and services. For example, we have worked closely with Cisco Systems, one of our primary suppliers, to develop new equipment and have been regular participants in its Technical Advisory Group. Through this and other cooperative programs, we strive to ensure that new hardware designs address the evolving requirements of our business and those of our customers.

In addition, we plan to work with innovative start-up companies to assist them in developing and implementing advanced technologies and converting these technologies into market-ready products and services. A key component of our strategy will be to develop strategic relationships with those start-ups that have technology or services that can help us expedite the execution of our business plan. The strategic nature of these relationships could take the form of acquisitions, technology transfers, equity investments or joint product development.

Our Customers

We primarily target enterprises and service providers. We have established a large and diversified base of enterprise customers in a wide range of industries, including financial services, manufacturing, media and publishing, consulting services and high technology. As of March 31, 2000, we had approximately 5,000 enterprise customers, the majority of which were located in the United States. The following is a representative list of our enterprise customers.

High Technology

Cabletron
Compaq
Microsoft
Sun Microsystems

Manufacturing

Carrier Corporation
FMC Corporation
Hasbro Interactive
Avid Technology

Media and Publishing

CNN
DoubleClick
Yahoo!
ZDNet

Consulting Services

Computer Sciences Corp.
ENTEX Information Systems
Hewitt Associates
Sapient

Other Services

Block Financial
e-Speed
Stanford University

Our customer base also includes many service providers, including application service providers, Internet service providers and telecommunications carriers. As of March 31, 2000, we had approximately 400 service provider customers, the majority of which were located in the United States. The following is a representative list of our service provider customers.

Consumer Internet Service Providers

America Online
Earthlink
NetZero
WebTV

Business Internet Service Providers

I.NET S.p.A.
iPass
Planet Online
Shore.net

Telecommunications Carriers

Pacific Gateway Exchange
Tiscali S.p.A.
TLD of Puerto Rico

Internet-Centric Related Services

Akamai Technologies
Dialpad
Digital Island

Our Relationship With America Online

We have supplied managed, dial-up access services in the United States to America Online since 1995. During the year ended December 31, 1999, America Online accounted for approximately 52% of our total revenues. We entered into a new agreement with America Online effective as of December 31, 1999, pursuant to which America Online has agreed to purchase additional dial-up Internet access services from us for a seven-year term through December 31, 2006. Under the new agreement, America Online has also agreed to purchase managed digital subscriber line and other broadband network access services from us for a five-year term through December 31, 2004. The components and resources used to provide dial-up access and broadband connections to our network backbone for America Online are dedicated to them and may not be used by us to service other customers. In addition, our Columbia, Maryland network operations center is dedicated to servicing America Online.

Dial-Up Services. Under the new agreement, America Online has committed to purchase from us agreed upon minimum quantities of dial-up network access services as measured by the number of dial-up access ports, or modems, available for America Online customers. America Online has agreed to increase the number of dial-up access ports to be managed by us through June 2002, subject to the terms and conditions of the agreement. America Online pays us a fixed monthly fee for each activated dial-up access port managed by us for it. Under the agreement, the monthly per access port fee to which we are entitled will be reduced at specified intervals over the term of the agreement. In addition, we have agreed, subject to limitations, that if we offer a third party better pricing for comparable dial-up access services than that paid by America Online, America Online may gain the benefit of this better pricing.

At specified times during the course of the new agreement, America Online has the right to seek a reduction in the fees paid to us for access ports based on the then prevailing market prices for comparable dial-up access services in the manner described in the new agreement. If we do not agree to reduce the fees we charge to America Online for the applicable dial-up access ports to the market price, America Online may, subject to advance notice and other limitations, terminate future dial-up service commitments to us and decommission an equal number of its existing dial-up access ports with us. Similarly, America Online may reduce its dial-up service commitments in the event we fail to meet monthly or geographic delivery targets.

Beginning January 1, 2003, America Online may, subject to advance notice and other limitations, decommission dial-up access ports managed by us in proportion to their decommissioning of dial-up access ports provided by other vendors. We are required to maintain a dedicated network operations center to service the portions of our network dedicated to America Online.

Broadband Services. Under the agreement, we also provide broadband services to America Online in connection with their digital subscriber line service offerings. America Online also has agreed to purchase additional network services from us in connection with its other broadband service offerings, including cable modem, wireless and satellite, as they offer additional broadband access options to their customers. America Online has committed to purchase from us the network services necessary to serve specified percentages of

their digital subscriber line and other broadband customers. In connection with providing digital subscriber line service to an America Online customer, America Online is responsible for providing its customers with the local access circuit and we are responsible for the interconnection of that circuit to our backbone, transmission of the traffic to America Online and the monitoring, management and control of the network.

We receive a specified monthly fee for each America Online digital subscriber line and other broadband customer for whom we provide network services. Under the agreement, America Online pays us monthly fees based on the number of America Online broadband customers that are connected to our network, which fees are subject to agreed upon reductions as the number of America Online digital subscriber line and other broadband customers for whom we are providing services increases. In addition, we have also agreed to extend broadband network services. At specified times during the course of the new agreement, America Online has the right to seek a reduction in the fee paid to us for broadband backhaul services based on then prevailing market prices for comparable broadband backhaul services. If we do not agree to reduce our fees to America Online for broadband network services to the market price in the manner described in the new agreement, America Online may, subject to advance notice and other limitations, terminate future broadband service purchase commitments to us and terminate existing broadband service. America Online may also terminate future broadband service purchase commitments in the event we fail to deliver services to a new local access and transport area within a specified period.

General. In providing America Online services under the agreement, we are obligated to comply with specified minimum service levels. Either party may terminate the agreement in the event the other party commits a material breach which is not cured within 30 days after notice of the breach. In addition, America Online has the right to terminate the agreement in the event of:

- repeated material breaches by us even if cured;
- a violation of the most favored customer pricing provisions;
- a total or near total outage of any of the services provided by us that, even if lasting fewer than 30 days, is widespread and prolonged;
- our inability to meet our service level commitments or to expand service availability as required under the agreement; and
- a change in control of us other than changes in control resulting from or arising out of the closing of the proposed merger of GTE and Bell Atlantic.

We are also obligated to provide America Online assistance in the 12 months following any termination of the agreement to ensure a smooth transition of services. The agreement provides America Online with a right of first refusal with respect to the sale of our dial-up network access business.

Under a separate agreement, we have agreed to provide dial-up network access services to America Online in Japan. This agreement includes similar provisions to those described above regarding minimum purchase requirements on the part of America Online Japan, market pricing adjustments, service level requirements and termination provisions.

Operations and Customer Support

We believe that a high level of operational and customer support is critical to our success in attracting and retaining enterprise and service provider customers. We provide superior customer support by understanding the evolving and often complex technical requirements and business objectives of our customers. We assist our customers by initially assembling design teams comprised of product specialists from all relevant areas of our organization, including Internet access, web hosting and security. These design teams work closely with our customers from the very beginning of the relationship to properly identify their Internet infrastructure requirements and design appropriate solutions. We also assign a project manager to this team when a customer is prepared to implement its solution. Our design teams can range from a small group for single service

solutions to a dedicated multi-discipline team for complex solutions. We also assign an implementation engineer to coordinate all of our activities with a customer. Our implementation engineers assist customers in developing operational processes and databases for use within their internal support environment after installation.

We provide toll-free phone access, as well as e-mail or facsimile access, to our customer support centers. In addition, our web-enabled customer service tools allow our customers to track order and service status and request upgrades online. In addition, we have event management teams available 24 hours a day, seven days a week, to work with the appropriate organizations in the event of any major Internet-wide event that disrupts service. In these circumstances, we also utilize our automated emergency broadcast capability to quickly reach our customer by e-mail, telephone, facsimile or pager.

We provide operational support for all services 24 hours a day, seven days a week. We also have network engineers and operational support agreements with our vendors to provide us with support 24 hours a day, seven days a week. Currently our primary Network Operations Center is located in our Burlington, Massachusetts headquarters facility. This Network Operations Center is supported by redundant power served from separate sources, extensive failover battery backup and dual, on premises power generation stations. We plan to relocate our primary Network Operations Center from Burlington, Massachusetts to our new Woburn, Massachusetts campus that is currently under construction. In addition, we have a Network Operations Center in Columbia, Maryland and are finalizing plans for a new Network Operations Center in the Dallas, Texas area to replace a facility we currently share with GTE. Our Columbia, Maryland Network Operations Center is dedicated to servicing America Online. We also have Operations Support Centers in Cambridge, Massachusetts and Chantilly, Virginia. Our centers can perform disaster back-up for other centers. Our data centers are designed with these same commitments to availability, and we guarantee these capabilities with service level guarantees.

Sales and Marketing

Within the United States, we rely primarily on a direct sales force. This direct sales force focuses on U.S.-based enterprises and service providers with domestic and international service requirements. Our sales force within the United States generally works with the managers of the marketing, sales or finance departments, as well as with information technology officers within the enterprise. In addition, through our eP@rtners program, we have formed alliances with leading web integrators, e-business consultants, interactive agencies and other technology providers, which increases our access to potential service provider and enterprise customers. Our current partners in this program include:

- Agency.com
- Cambridge Technology Partners
- Cisco Systems
- Ernst & Young
- Hewlett-Packard
- IBM
- Lante
- Microsoft
- Nortel Networks
- Sapient

These alliances enable us to provide comprehensive e-business solutions and also serve as a valuable, cost-effective channel for marketing our services. We also plan to expand our existing reseller relationships to significantly enhance our distribution capabilities.

Internationally, we have both a direct sales force and a channel partner program, which we call our Net.Alliance program. Our international direct sales force focuses primarily on the international service provider segment, while our Net.Alliance partners are our primary channel to multinational companies based outside of the United States. Many of our Net.Alliance partners are both customers and resellers of our services. This channel gives us distribution capabilities in over 14 countries globally. Our current partners in this program include Energis in the United Kingdom and Tiscali and I.NET in Italy.

All of our sales representatives participate in extensive technical and consultative sales training programs that we believe enable them to better comprehend, respond to and resolve the complex networking problems of our customers. As of March 31, 2000, we had a direct sales force of over 350 people.

We only recently changed our name to Genuity. To be successful, we must establish and strengthen our brand recognition. We intend to incur significant expenses to promote our brand. Our marketing organization is responsible for developing the strength and awareness of the Genuity brand on a local, national and international basis. We intend to build brand awareness through a variety of methods, including radio, print advertising in trade journals and special-interest publications and our web site. In addition, we also employ public relations personnel in-house and work with an outside public relations agency to provide broad coverage in the Internet and computer networking fields. To a limited extent, we also directly market our services at seminars and trade shows such as Internet World, ISPCon, COMnet, CeBit and various Gartner Group information technology conferences.

Competition

The market for Internet infrastructure services is extremely competitive and subject to rapid technological change. We expect to encounter increased competition in the future as a result of increased consolidation and development of strategic alliances in the industry. In addition, we will compete with foreign service providers as we expand internationally and as these service providers increasingly compete in the United States market. Our principal competitors in the Internet infrastructure services market may be divided into Internet infrastructure service providers and niche players offering services competitive with one or more of our services.

Internet Infrastructure Service Providers. We are recognized by industry sources as one of a limited number of Tier 1 Internet backbone providers that offer managed Internet infrastructure services. Accordingly, we believe our primary competitors are those Internet infrastructure service providers that offer a similar breadth of services and possess the on-network users and content to offer their customers connectivity to virtually all addresses on the Internet, either through their Internet backbone or through high speed private peering relationships that permit them to have direct, cost-free exchange of traffic with a significant number of carriers and other Internet service providers. These competitors include UUNET Technologies, a subsidiary of WorldCom, AT&T, Cable & Wireless and Sprint. UUNET has substantially greater market share than we do, and some of the others also have greater market share than we do. UUNET is a competitor for America Online's access requirements and is reported to provide a substantial portion of those requirements. In addition, WorldCom and Sprint have announced a proposed merger. We believe this proposed merger would substantially increase the market share and competitive position of UUNET, even if it were required to divest itself of portions of its Internet backbone as a condition to the merger. Some of these competitors also are able to bundle their Internet service offerings with non-Internet data services, such as frame relay, and traditional voice services, such as local and long distance, thereby reducing the price of their services relative to ours. We may not be able to offset the effects of any price reductions because we only offer IP-based services. We also compete with an increasing number of Internet service providers that have a significant regional, national or international presence but do not offer as broad a range of services or possess fewer users and less on-network content than the infrastructure service providers listed above. These competitors include, among others, Level 3 Communications, Qwest Communications, KPNQwest, Deutsche Telekom, PSINet, Verio Communications and Williams Communications Group. As a result of the increase in the number of competitors and the vertical and horizontal integration that is occurring in this industry, we currently encounter and expect to continue to encounter significant competition, which could force us to, among other things, reduce our rates and invest more heavily in infrastructure.

We believe we compete with these competitors primarily on the basis of quality and quantity of on-network users and content, breadth of service offerings, geographic reach and quality of network infrastructure, capacity, quality of service and price. While we believe that our network infrastructure, comprehensive suite of services and expertise in designing, developing and implementing managed Internet infrastructure solutions distinguish us

from our competitors, many of our existing and potential competitors have greater financial and other resources, more customers, a larger installed network infrastructure, greater market recognition and more established relationships and alliances in the industry. As a result, these competitors may be able to develop and expand their network infrastructure and service offerings more quickly, adapt more swiftly to new or emerging technologies and changes in customer demands, devote greater resources to the marketing and sale of their offerings, pursue acquisition and other opportunities more readily and adopt more aggressive pricing policies.

Niche Players. There are numerous competitors that service generally one or a small number of the specific Internet infrastructure requirements of enterprise customers. These competitors include, among others:

- web-hosting companies, such as Digex and Exodus Communications;
- broadband Internet access providers such as Covad Communications and Rhythms NetConnections, both of which focus on digital subscriber line services;
- providers of security and virtual private networks, such as Pilot Network Services; and
- transport service providers, such as Level 3 Communications, Qwest Communications and Williams Communications Group.

We believe that there are relatively few barriers to entry in these markets. We compete with these niche players on the basis of technical expertise, quality of service, reliability and price.

There are numerous other companies from a variety of industries that have also focused on our target market. For example, many of the major cable companies have begun offering, or are exploring the possibility of offering, Internet access through their current networks to include Internet access capabilities. Direct broadcast satellite and wireless communications providers have also entered the Internet access market with various wireless and satellite-based service technologies. We believe that direct broadcast satellite and wireless communications providers have also entered the Internet access market.

As we continue to expand our operations in markets outside the United States, we will also encounter new competitors and competitive environments. Our foreign competitors may enjoy a government-sponsored monopoly on telecommunications services essential to our business, and will generally have a better understanding of their local industry and longer working relationships with local infrastructure providers.

Employees

As of March 31, 2000, we had a total of 3,557 employees, of which 1,263 were in customer service and support, 866 were in engineering, 761 were in sales and marketing, 345 were in information technology and 322 were in finance and administration. We believe that relations with our employees are good. Our employees are not represented by any collective bargaining agreement.

Real Estate Facilities

We currently occupy our headquarters and primary Network Operations Center in Burlington, Massachusetts under a lease that expires in 2009. This lease includes renewal options for two three-year periods. We are constructing a two-building campus in Woburn, Massachusetts that is scheduled for completion in the next 12 months. We plan to move our corporate headquarters operations, including executive staff, finance, human resources and information technology organizations, to our Woburn, Massachusetts campus. We anticipate that our network operations organization, including our primary Network Operations Center, also will relocate from Burlington, Massachusetts to Woburn, Massachusetts. We intend to retain our Burlington, Massachusetts facility to house our engineering, sales and marketing and service line organizations. We lease space for our other Network Operating Center in Columbia, Maryland and are finalizing plans for a new Network Operations Center in the Dallas, Texas area to replace a facility we currently share with GTE.

Proprietary Rights

We rely on a combination of patent, copyright, trademark and trade secret laws and contractual restrictions to establish and protect our technology. We own, either exclusively or jointly, an interest in nearly 200 inventions that are the subject of patents, patent applications or patent disclosures. These legal protections provide only limited protection. Further, the market for Internet infrastructure services is subject to rapid technological change. Accordingly, while we intend to continue to protect our proprietary rights where appropriate, we believe that our success in maintaining a technology leadership position is more dependent on the technical expertise and innovative abilities of our personnel than on these legal protections.

Despite our efforts to protect our proprietary technology, we cannot assure you that the steps taken by us will be adequate to prevent misappropriation of our technology or that our competitors will not independently develop technologies that are substantially equivalent or superior to our technology. The laws of many countries do not protect our proprietary technology to as great an extent as do the laws of the United States. We may need to resort to litigation in the future to enforce our intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of invalidity. We are also subject to the risk of adverse claims and litigation alleging infringement of the intellectual property rights of others. Any resulting litigation could result in substantial costs and diversion of management and other resources and could have a material adverse effect on our business and financial condition. ◀

Regulatory Matters

The following summarizes regulatory developments and legislation that we believe are currently material to us. It does not describe all present and proposed federal, state, local and foreign regulation and legislation affecting the telecommunications industry.

Our existing and planned Internet operations are not actively regulated by the Federal Communications Commission or any other government agency of the United States at the present time, other than regulations that apply to businesses generally. However, one of our wholly owned subsidiaries is classified as an “interexchange carrier” and provides primarily private-line data services. As a result, this subsidiary is regulated as a telecommunications carrier and is subject to the requirements described below under “Telecommunications Services”. Furthermore, the regulations governing the telecommunications industry generally are often subject to regulatory, judicial, or legislative modification and are in a state of flux at the present time. Some private parties and regulators have called the current regulatory status of various Internet service offerings into question.

We cannot predict the actions of the regulatory authorities that have jurisdiction in this area or whether any of these authorities will attempt to impose new regulations on Internet services or expand their interpretations of existing regulations to make them apply directly to Internet services. Accordingly, we do not know whether current or future regulations could have a material adverse effect on us. If any regulatory authority imposes new regulations or expands their interpretations of existing regulations to make them applicable to Internet operations, some or all of the following rules may be applied to those operations. However, if new regulations are imposed on our industry, or existing regulations are expanded to cover our industry, these regulations will almost certainly also apply to all similarly situated parties offering comparable services, including our competitors.

Federal Telecommunications Regulation

Federal regulations have undergone major changes in the last four years as the result of the enactment of the Telecommunications Act. The Telecommunications Act is the most comprehensive reform of the telecommunications law in the United States since the Communications Act was enacted in 1934. For example, the Telecommunications Act imposes interconnection and access requirements on telecommunications carriers and on all local exchange carriers, including incumbent local exchange carriers and competitive local exchange carriers. |

Under the current regulatory regime, communications related services are generally classified into one of the following three definitional categories:

- information services;
- private carrier services; and
- telecommunications services or common carriage.

Because the boundaries between these categories are neither precise nor well-fixed, and the industry is so dynamic, we cannot predict where particular services will be classified, now or in the future. The regulations associated with each type of classification are described below.

Information Services. Except for the provision of underlying basic transmission capability, Internet services have generally been considered to be "information services". Under current law, operators of information services are exempt from regulation by the FCC, but operators of telecommunications services are not similarly exempt. However, the FCC continues to review its regulatory position on the usage of the basic network and communications facilities used by Internet service providers. Whether it will assert regulatory authority over the Internet, and the level of any asserted authority, is a pending issue. While the FCC has determined in an April 1998 report to Congress that Internet access providers should not be treated as telecommunications carriers and therefore should not be regulated, it is expected that the status of various types of Internet service providers will continue to be uncertain.

In the same report, the FCC also concluded that some of the services currently offered over the Internet, such as phone-to-phone IP telephone services, may be functionally indistinguishable from traditional telecommunications service offerings, and that their non-regulated status may have to be reexamined. The report also indicated that the FCC would determine on a case-by-case basis whether to subject IP telephone service providers to regulation, including whether to require them to contribute financially to universal service support mechanisms, which could also subject these services to other forms of regulation. The FCC has also stated that it may require Internet service providers that use their own transmission facilities to provide Internet access services to contribute to universal service mechanisms, and has previously considered and rejected the possibility of regulating Internet backbone peering arrangements, although that issue remains subject to further review.

Private Carrier Services. The offering of private carrier services typically entails the offering of telecommunications to a limited class of users on the basis of individually negotiated terms and conditions. As a result, they do not meet the definition of a telecommunications service under the Telecommunications Act. These private carriers are generally unregulated by the FCC, but are subject to regulation for intrastate offerings in some states and incur universal service payment obligations, discussed below, based on their gross revenues from end users. These private carriers may also be subject to access charges if interconnected to local exchange facilities.

Telecommunications Services. A significant amount of regulation applies to providers of telecommunications services. The Communications Act defines telecommunications carriers as entities offering telecommunications services, which are in turn defined as the offering of telecommunications for a fee, directly to the public or to classes of users so as to be effectively available directly to the public. The law does not distinguish on the basis of the facilities used to provide these services. "Telecommunications" is defined as the transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received. The FCC has found that the definition of "telecommunications carrier" is essentially the same as the definition of "common carrier". Telecommunications carriers are subject to regulatory requirements that may impose substantial administrative and other burdens on their operations.

The FCC imposes regulations on some common carriers that have been found by the FCC to have some degree of market power, otherwise known as dominant carriers. The FCC imposes less regulation on other common carriers, which have been found not to have market power, otherwise known as "non-dominant carriers". A subsidiary of GTE is classified as a non-dominant carrier. These non-dominant carriers do not need

express prior authorization to provide domestic services and can file tariffs on one day's notice. The FCC requires common carriers to obtain a formal authorization to construct and operate telecommunications facilities and to provide or resell telecommunications services between the United States and international points. The FCC also regulates carrier exits from markets.

General Obligations. All telecommunications carriers are subject to the complaint process and rules and regulations of the FCC, as well as various other requirements set out in Title II of the Communications Act of 1934, as amended. In addition, telecommunications carriers have general obligations, including the following:

- not to charge unreasonable rates or engage in unreasonable practices;
- to provide service on reasonable request;
- not to unreasonably discriminate in their service offerings;
- to comply with reporting requirements;
- to offer customer premises equipment for sale on an unbundled basis to the extent that it is offered;
- to allow resale of their services in some circumstances; and
- to restrict their use of customer information.

In addition, telecommunications carriers are subject to further regulatory requirements, some of which are discussed in greater detail below. Telecommunications carriers must also pay regulatory fees associated with filing license applications and other documents with the FCC.

Interconnection Obligations. All telecommunications carriers have the basic duty to interconnect and interoperate, either directly or indirectly, with the facilities of other telecommunications carriers.

Section 214 Authorizations. Common carriers are obligated to obtain, under Section 214 of the Communications Act, authorization from the FCC to provide services between the United States and other countries, and to disclose, among other things, the extent to which they are owned or controlled by foreign entities. The compliance with these regulatory requirements imposes administrative and other burdens on these carriers.

Tariffs and Pricing Requirements. The FCC has eliminated the requirements that non-dominant interstate interexchange carriers maintain tariffs on file with the FCC for domestic interstate services. One of our wholly owned subsidiaries is a non-dominant interstate interexchange carrier. Under the rules of the FCC, after a transition period currently scheduled to expire on January 31, 2001, relationships between interstate carriers and their customers would be set by contract. At that point, the FCC would no longer permit the use of tariffs for interstate, domestic interexchange services. Competitive local exchange carriers do not have to file tariffs for their exchange access services, but may if they choose to do so. The FCC is considering whether to impose mandatory detariffing on them as well. There has been no proposal to detariff international services.

Customer Proprietary Network Information. The use by a telecommunications carrier of customer proprietary network information, which generally includes any information regarding a subscriber's use of a telecommunications service obtained by a carrier solely by virtue of the carrier-customer relationship, is subject to statutory restrictions. This customer proprietary network information does not include a subscriber's name, telephone number and address, if that information is published or accepted for publication in any directory format. A telecommunications carrier may use a customer's proprietary network information only to market a service that is "necessary to, or used in" the provision of a service that the carrier already provides to the customer, unless it receives the customer's prior oral or written consent to use that information to market other services. The initial rules of the FCC regarding customer proprietary network information have been struck down in the courts and other rules adopted on reconsideration have not gone into effect, leaving the current state of the customer proprietary network information requirements uncertain. The FCC is expected to initiate

further proceedings to address this issue. Any such rules, either as adopted or as modified, may impede the ability of a telecommunications carrier to effectively market integrated packages of services and to expand existing customers' use of its services.

Universal Service. The FCC has recently expanded aid to schools and libraries and extensively revamped the support structure for high cost-of-service areas. These providers of interstate telecommunications services, as well as some other entities, such as private carriers offering excess capacity to end user customers, must contribute to a fund to pay for these programs. The schools and libraries and rural health care support mechanisms are assessed against interstate and international end-user revenues. The contribution level and overall size of federal support may change. Several petitions for administrative reconsideration of various FCC universal service orders are pending, and there are a number of other proceedings relating to universal service at the FCC and federal courts of appeals that are still ongoing. The rules of the FCC also require that telecommunications carriers contribute to the Number Portability Fund, the Telecommunications Relay Services Fund and the North American Numbering Plan Administrator Fund.

Communications Assistance for Law Enforcement Act. Telecommunications carriers may incur significant expenses to assure that their networks comply with the requirements of the Communications Assistance for Law Enforcement Act. Under this statute, telecommunications carriers are required to:

- provide law enforcement officials with call content and call identifying information pursuant to a valid electronic surveillance warrant; and
- provide sufficient capacity for use by law enforcement officials in executing authorized electronic surveillance.

While the telecommunications industry is attempting to negotiate legislative and administrative provisions that would compensate carriers for some of the costs associated with complying with this statute, as it stands today those issues have not been definitively resolved.

Local Exchange Carriers. Telecommunications carriers that are classified as local exchange carriers are subject to special regulatory provisions, in addition to those described above. A local exchange carrier is defined as a provider of telephone exchange service or exchange access. Telephone exchange service is defined as service within a telephone exchange or connected system of exchanges operated to provide inter-communicating service of the character ordinarily furnished by a single exchange, covered by the local exchange charge, or comparable service provided through a system of switches, transmission equipment or other facilities, or combination thereof, by which a subscriber can originate and terminate a telecommunications service. The universe of carriers that are classified as local exchange carriers has never been fully defined by the FCC. If an entity is found to be a local exchange carrier, it will have the following obligations:

- Reciprocal Compensation. This requires all local exchange carriers to establish compensation arrangements with other carriers for the transport and termination of telecommunications.
- Resale. This requires all local exchange carriers to permit resale of their telecommunications services without unreasonable restrictions or conditions.
- Number Portability. This requires all local exchange carriers to permit users of telecommunications services to retain existing telephone numbers without impairment of quality, reliability or convenience when switching to another service provider at the same location.
- Non-discriminatory Access and Dialing Parity. This requires all local exchange carriers to provide nondiscriminatory access to telephone numbers, operator services, directory assistance and directory listing with no unreasonable dialing delays and to give customers access to their selected carrier without having to dial extra digits.

- Access to Rights-of-Way. This requires all local exchange carriers to permit competing carriers access to poles, ducts, conduits and rights of way at reasonable and nondiscriminatory rates, terms and conditions.
- Section 272 Restrictions. Under the Telecommunications Act, Bell operating companies, including the Bell Atlantic local telephone operating companies, are subject to additional restrictions. In particular, Section 272 of the Telecommunications Act requires Bell operating companies to offer manufacturing and specified long distance services through a separate affiliate. Once Verizon owns more than 10% of the capital stock of Genuity, Genuity will be considered an affiliate that must be separated from and must operate independently from the Bell Atlantic local telephone operating companies. Any transactions with the affiliated telephone operating companies must be publicly disclosed. Moreover, in its dealings with the separate affiliate, a telephone operating company may not discriminate in the provision or procurement of goods, services, facilities, and information, or in the establishment of standards. The joint marketing and sale of long distance services is not considered to violate the nondiscrimination provisions of the statute. Other than specific nondiscrimination requirements, the obligations of Section 272 of the Telecommunications Act will no longer apply three years after a Bell operating company or its affiliates is authorized to provide long distance telecommunications services under Section 271(d) of the Telecommunications Act, unless that period is extended by the FCC by rule or order.

In its proposal to the FCC, Verizon has agreed once it has eliminated applicable Section 271 restrictions and is able to exercise its conversion rights, it will comply with Section 272 to the same extent that Section 272 would apply if Verizon exercised its conversion rights.

In addition, incumbent local exchange carriers also face additional pricing, network unbundling, and other obligations.

State Telecommunications Regulation

States also regulate telecommunications services, including through certification of providers of intrastate services, regulation of intrastate rates and service offerings, and other regulations. The Telecommunications Act prohibits state and local governments from enforcing any law, rule or legal requirement that prohibits or has the effect of prohibiting any person from providing any interstate or intrastate telecommunications service. In addition, under current policies of the FCC, any dedicated transmission service or facility that is used more than 10% of the time for the purpose of interstate or foreign communication is subject to the jurisdiction of the FCC. Under the Telecommunications Act, states retain jurisdiction to adopt regulations necessary to preserve universal service, protect public safety and welfare, ensure the continued quality of communications services and safeguard the rights of consumers. Accordingly, the degree of state involvement in local telecommunications services may be substantial. Furthermore, states generally give municipal authorities responsibility over the access to rights-of-way, franchises, zoning, and other matters of local concern, which means that localities may also have involvement in the regulation of the telecommunications industry.

Other Potential Regulation

The laws and regulations relating to the liability of Internet access providers for information carried on or disseminated through their networks are currently unsettled both in the United States and abroad. In the United States, the Children's Online Protection Act of 1998 imposes criminal penalties and civil liability on anyone engaged in the business of selling or transferring material that is harmful to minors by means of the Internet without restricting access to this type of material by underage persons. In addition, similar legislation has been passed or is being considered in many states and foreign jurisdictions. Several private lawsuits seeking to impose this type of liability on online service companies and Internet access providers are pending. The imposition of potential liability on us and other Internet access providers for information carried on or disseminated through our systems could require us to implement measures to reduce our exposure to this liability, which may require the expenditure of substantial resources or the discontinuance of various service

offerings. While we carry professional liability insurance, it may not cover this type of liability and otherwise may not be adequate to compensate us for any damages or costs incurred in defending against these claims. The costs of defending against any claims and potential adverse outcomes of these claims could have a material adverse effect on our business.

Due to the increase in Internet use and publicity, it is possible that other laws and regulations that apply to commerce and communication over the Internet will be adopted. The United States Congress has recently enacted or considered enacting Internet laws regarding children's privacy, copyrights, the transmission of sexually explicit material, the taxation of Internet services and transactions and universal service contribution requirements for Internet access providers. The European Union also recently enacted its own privacy regulations. The laws governing the Internet, however, remain largely unsettled, even in areas where there has been some legislative action. It may take years to determine whether and how existing laws such as those governing intellectual property, telecommunications, privacy, libel, taxation and other issues apply to the Internet. In addition, the growth and development of the market for electronic commerce may prompt calls for more stringent consumer protection laws, both in the United States and abroad, which may impose additional burdens on companies conducting business over the Internet.

Other companies in our industry are not generally subject to direct regulation by the FCC or any other governmental agency of the United States, other than regulations that apply to all business organizations. However, in connection with the merger between Bell Atlantic and GTE, the FCC has reviewed our relationship with Verizon. In addition, the FCC continues to review its regulatory position on the usage of the basic network and communications facilities by Internet companies. To the extent that future regulatory licenses or permissions are necessary or useful for us to provide IP-based services, we will seek to obtain those licenses and permissions.

Recently, the FCC adopted rules that direct incumbent local exchange carriers to share their telephone lines with providers of high speed Internet access and other data services. This ruling enables competitive carriers to provide digital subscriber line-based services over the same telephone lines simultaneously used by incumbent local exchange carriers to provide basic telephone service. These changes may increase competitive pressures on incumbent local exchange carriers in the offering of advanced telecommunications services, including digital subscriber line services.

International Regulatory Matters

The laws relating to the provision of Internet and telecommunications services in other countries vary substantially from country to country and are undergoing a rapid process of development and change. There are a variety of regulations in different jurisdictions regarding authorizations to provide services and the manner in which services are to be provided. In addition, some countries impose liability for providing access to prohibited content and restrict the transfer of personal information. As we continue to expand into international markets, these laws will have an increasing impact on our operations. We do not know whether new or existing laws or regulations could have a material adverse effect on us or our ability to offer some or all of our services in any country.

The ability for us to provide some or all of our Internet and other services, including the ownership and operation of the necessary assets and facilities in any particular country, will depend upon the extent to which applicable laws and regulations permit us to provide our services. We believe that the provision of some services, such as our voice-over-IP services, is more likely to be subject to local country regulation than other Internet services provided by us. Foreign countries treat voice-over IP differently. Some countries impose no regulation on the service, while others allow voice-over-IP but grant only a limited number of licenses to providers. In some instances, the country requires licenses, but will grant an unlimited number of licenses to providers. Finally, there are some countries that prohibit the service altogether. Whether an entity can provide voice-over-IP services in any given country thus heavily depends on local regulations and the actions of local governments.

We currently have the ability to provide Internet services in many countries without obtaining regulatory authorizations, approvals, or licenses. In eight countries where we currently have or are in the process of commencing operations, we have either obtained or have applied for regulatory approvals, authorizations, or licenses for at least some of these services. These eight countries include Brazil, Germany, Ireland, Italy, Japan, Mexico, The Netherlands and Spain. In addition, as we enter new markets, we anticipate obtaining similar approvals, authorizations and licenses as required by applicable local rules and regulations in order to acquire, own and operate the necessary assets and facilities, and to provide services, in these countries. We do not know if we will obtain the necessary local regulatory approvals to own and operate the assets and facilities necessary to provide service, or to provide the services themselves, in any country, or that local country laws or regulations will not change. Any failure to obtain approvals, or loss of authorization, to provide services in any country could have a material adverse effect on us.

Legal Proceedings

We are not involved in any legal proceedings which we believe would, if adversely determined, have a material adverse effect upon our business, financial condition or results of operations.